Internal Revenue Service
# memorandum

CC:TL-N-7042-91
Br2:JMSchwartzman

date: JUN 3 1991

to: Assistant District Counsel, Manhattan CC:MAN

from: Chief, Branch 2, Tax Litigation Division CC:TL:Br2

subject: [redacted]--Estoppel

This memorandum responds to your May 17, 1991, request for assistance concerning the estoppel issue raised by petitioners in this case.

## ISSUE

[redacted] executed two contracts for the performance of services. The first was with its foreign parent, which provided for the payment for services rendered according to a sliding fee schedule. The second contract was between [redacted] and [redacted]. That contract provided that [redacted] would perform services for [redacted] according to the same sliding fee schedule granted to its foreign parent. On audit, the agent did not increase the amount of service income [redacted] received from [redacted] because [redacted] would receive an identical increase in its deductions, resulting in a virtual "wash" for U.S. tax purposes. Because the Service did not dispute the arm's-length nature of the [redacted] contract, is it estopped from disputing the arm's-length nature of the fee schedule in the [redacted]-foreign parent contract for the same taxable year?

## FACTS

Manhattan District Counsel is currently writing the brief in this case. At trial, [redacted] seemed inclined to side with the petitioners that the Service is precluded from disputing the arm's-length status of a payment received by [redacted] for services it rendered to its foreign parent because it did not raise that issue for the same taxable year with respect to identical terms between [redacted] and another United States corporation controlled by the same interests. On brief, we would like to defend with pertinent case law the position that the Service is not bound by any duty of consistency on these facts.

The facts underlying this dispute are as follows. [redacted] is owned by a foreign corporation which, in turn, is owned by another foreign corporation, which is owned by a foreign holding company. That foreign holding company also owns another United States corporation, [redacted] ([redacted]).

[redacted] has a contract with its foreign parent for the provision of services. [redacted] is paid for the services it renders to its parent according to a sliding schedule of fees. [redacted] also has a contract for services with [redacted] according to which [redacted] provides services to it for the same price it provides those services to its parent.

On audit, the agents did not claim that the amount of income [redacted] received from [redacted] was inadequate because, the greater the income received by [redacted], the greater the deduction for [redacted], resulting in a virtual "wash" for federal income tax purposes. The agents did claim, however, that the amount of income received by [redacted] on its service contract with its foreign parent was inadequate. In that instance, the increased service income to [redacted] did not entail a larger deduction for United States tax purposes because its parent is a foreign corporation.

As noted above, [redacted] seemed sympathetic to petitioner's argument that because we did not challenge the arm's-length status of the payments received by [redacted] pursuant to the [redacted] contract, we are estopped from raising that issue with respect to the [redacted]-foreign parent contract for the same year.

## CONCLUSION

We conclude that the Service is not estopped from disputing the arm's-length nature of the [redacted]-foreign parent contract. This conclusion is based on the fact that [redacted] did not specially plead estoppel in its petition. This conclusion is also based on the fact that (1) the service made no representation to the petitioner with respect to this issue, (2) there was no reliance by the petitioner, (3) the petitioner knew that the fee schedule did not represent an arm's-length payment for the services rendered and (4) there was no harm to the petitioner by virtue of the Service's choice not to raise this issue with respect to the [redacted] contract.

## DISCUSSION

Petitioner's claim is one of equitable estoppel (quasi-estoppel) or duty of consistency. Estoppel, as an affirmative defense, must be specially plead or it is waived. Rose v. Commissioner, 55 T.C. 28 (1970); Lodi Iron Works, Inc. v.

Commissioner, 29 T.C. 696 (1958). [redacted]"). In addition, taxpayers have the burden of proof on the issue. First National Bank of Montgomery v. United States, 176 F. Supp. 768, 772 (M.D. Ala. 1959), aff'd per curiam, 285 F.2d 123 (5th Cir. 1961) ("... there is a legal presumption to the effect that defendant is not so estopped in such cases and the burden to prove equitable estoppel is upon plaintiff."); Saigh v. Commissioner, 36 T.C. 395 (1961); United States Trust Co. of New York, 13 B.T.A. 1074 (1928).

Petitioner's argument appears to be based on Treas. Reg. § 1.482-1(d)(2). That regulation provides that, "Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as 'primary' adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. ... Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U.S. income tax liability of the other member for any pending taxable year."

Here, the correlative adjustment to [redacted]'s increased service income is an increased deduction to [redacted]'s parent corporation. Since its parent is a foreign corporation, however, no such adjustment is required because the adjustment would not, "have an effect on the U.S. tax liability of the other member for any pending taxable year." Since the increased service income to [redacted] pursuant to the [redacted]-foreign parent contract does not involve [redacted], no correlative adjustment is required. Only if the Service had increased [redacted]'s income pursuant to the [redacted] contract would a correlative adjustment have been required. Petitioner's attempt here to turn the regulations upside down and inside out by claiming that the failure to make an adjustment with respect to one contract, estops the Service from making an adjustment on a similar contract is just not supported by the regulations.

It is well settled that if the Service fails to make an adjustment or raise an issue with respect to a taxpayer for prior years, it is not estopped from doing so for current years. Thomas v. Commissioner, 92 T.C. 206, 225 (1989) ("We will not accept petitioners' invitation to convert respondent's 1959 error into a permanent license to distort petitioners' income."); Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397, aff'd, 481 F.2d 812 (10th Cir. 1973). See also Madison Gas & Electric

Co. v. Commissioner, 72 T.C. 521, aff'd, 633 F.2d 512 (7th Cir. 1980); Joseph Gann, Inc., 43 T.C.M. 682, aff'd per curiam, 701 F.2d 3 (1st Cir. 1982), cert. denied, 464 U.S. 821 (1983). In addition, the doctrine of equitable estoppel should be applied against the Commissioner only with the "utmost caution and restraint." Estate of Emerson v. Commissioner, 67 T.C. 612, 617 (1977); Schuster v. Commissioner, 312 F.2d 311 (9th Cir. 1962); Smales & Robinson, Inc. v. United States, 123 F. Supp. 457, 464 (S.D. Cal. C.D. 1954) ("Public Policy demands that the mandate of the law should override any doctrine of estoppel."); Vestal v. Commissioner, 152 F.2d 132 (DC Cir. 1945); New York Athletic Supply Co., Inc. v. United States, 450 F. Supp. 469 (S.D.N.Y. 1978). See also Goldberg v. Weinberger, 546 F.2d 477 (2d Cir. 1976), cert. denied, 431 U.S. 937 (1977); Zuanich v. Commissioner, 77 T.C. 428, 432 (1981) ("On this record, we would not invoke the doctrine of equitable estoppel, even were we allowed to do so.") ([redacted] fully concurring with the majority in this reviewed opinion on the disposition of the foreign tax credit issue (including estoppel), but dissenting on the investment tax credit issue).

Quasi-estoppel is invoked when there is a governmental representation relied upon by a taxpayer to his detriment in a factual context producing harsh results. Estate of Emerson, 67 T.C. 612, 618 (1977) ("While there are exceptions to the general proposition that the estoppel doctrine is inapplicable to prevent respondent from correcting a mistake of law, these exceptions apply only in those rare instances where the equitable interest of the party asserting estoppel is 'compelling' and the loss which it would sustain is 'unwarrantable' and 'unconscionable.'"); Saigh, at 423 ("... in our view the facts do not warrant a finding that respondent is estopped ... We need only comment that there was no fraud, concealment, misrepresentation, omission, negligence, violation of duty, or unfair conduct on the part of respondent.") On our facts, the Service's failure to adjust the service income and correlative deduction pursuant to the [redacted] contract cannot be considered a representation. Silence constitutes a representation only when there is a duty to speak and section 482 specifically provides that the Secretary may distribute, apportion or allocate gross income.... New York Athletic Supply Co., Inc., at 471-472 ("Duty being absent, there was no misrepresentation by silence."); Interstate Fire Insurance Company v. United States, 215 F. Supp. 586 (E.D. Tenn. 1963). See also Recio v. Commissioner, T.C. Memo 1991-215 (Filed May 16, 1991). Thus, the Service cannot be said to have made a factual misrepresentation in this regard. In addition, [redacted], even if it proved some sort of reliance, was not damaged by the "representation." Indeed, by not raising the issue with respect to the [redacted] contract, [redacted] benefitted by not being required to include additional amounts in its gross income.

Thus, there is no harsh result which would require the application of equitable estoppel. See Schuster v. Commissioner, at 317 ("It is conceivable that a person might sustain such a profound and unconscionable injury on reliance on the Commissioner's action as to require, in accordance with any sense of justice and fair play, that the Commissioner not be allowed to inflict the injury. It is to be emphasized that such situations must necessarily be rare, for the policy in favor of an efficient collection of the public revenue outweighs the policy of the estoppel doctrine in its usual and customary context."). See also Roberto v. United States, 518 F.2d 1109, 1112 (2d Cir. 1975) ("... appellant contends that the Government by accepting his tax returns for eleven years without notice of his liability for the cabaret tax is estopped from later assessing the tax against him. Although the result here does seem harsh, there is no basis for such estoppel." (citing Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957))); Altman v. Connally, 456 F.2d 1114 (2d Cir. 1972); Schwager v. Commissioner, 64 T.C. 781, 789 (1975) ([redacted] stating, "Petitioner has not shown a misrepresentation of material fact by respondent. ... The fact that the estate has distributed all its assets to the sole beneficiary and executrix does not constitute sufficient harmful change in position to justify invoking estoppel against respondent."). Moreover, it may be argued, that [redacted] knew that the fee schedule for services did not represent arm's-length amounts and, therefore, is not entitled to equitable relief.

In Interstate Fire Insurance Company, supra, the Service requested plaintiff to perform work necessary to reallocate expenses under section 482. At that time, the tax consequences of the reallocation were unknown and the plaintiff understood that a reassessment of taxes would be made on the basis of the reallocation. The plaintiff performed the work in a manner approved by the Government at a cost of $25,000 to plaintiff. The court concluded that the Government was estopped from denying plaintiff's claim for refund based upon the reallocation for the year to which the reallocation work related. The court further concluded that the Government was not estopped to allocate or not allocate pursuant to section 482 with respect to any other year. The court based its conclusion on the circumstances which reasonably led plaintiff to believe that the results of the reallocation would form the basis of a reassessment of taxes.

The facts of our case are completely different from those in Interstate Fire. Here, the Service did not request [redacted] (or [redacted]) to perform reallocation work pursuant to section 482. While it is understandable that a court may chose to invoke equitable estoppel against the Government where the Government requests a taxpayer to do work under the pretext of a section 482 reallocation, it defies logic to apply equitable estoppel against the Government to prevent it from making a section 482 allocation in connection with a contract where the Government chose not to apply section 482 to a similar contract for the same taxable year, as it is permitted to do in its discretion pursuant to section 482.

In Norden-Ketay Corporation v. Commissioner, 319 F.2d 902 (2d Cir. 1963), a revenue agent informed the taxpayer that liquidating dividends would not be taxable as income to the recipients in the event of the corporation's continued existence and that there would be $3,150,582 in available loss carryforwards. Subsequently, the corporation divested itself of its loss assets and acquired income-producing assets, with less than three percent of the original shareholders remaining as shareholders. The court held that the Commissioner was not estopped from asserting a deficiency despite the agent's prior favorable statement concerning the loss carryforward. The court noted that the agent's statement was, "merely a summary of mathematical calculations made in a different context and represented no determination whatever that the operating loss would be available to different shareholders to offset the profits of another business. Even if such a determination had been made, it would have been a mistake of law which would work no estoppel." Norden-Ketay, at 907.

Similarly, the revenue agent's determination that no adjustment should be made regarding the [redacted] contract constituted a calculation in a different context. That context revealed that there would be no net effect for federal income tax purposes if an adjustment were made. The [redacted]-foreign parent contract, however, represents a different context in which an adjustment does in fact alter the net federal income tax consequences. As in Norden-Ketay, the "representation" that no adjustment is necessary to the [redacted] contract does not represent a determination that no adjustment would be necessary to the [redacted]-foreign parent contract.

In Joseph Gann, Inc., supra, the petitioner purchased blocks of stock in another corporation at different times. Upon subsequent sale of portions of such stock, the petitioner calculated its basis in the stock for purposes of computing gain according to the average-cost method. The Service subsequently required the petitioner to calculate its basis on the first-in, first-out (FIFO) method under the section 1012 regulations. The petitioner argued that the Service was estopped from requiring it to use the FIFO method because the Service had not challenged petitioner's use of the average-cost method on prior audits. The court dismissed petitioner's argument based on the well established notion that the Service is not estopped from challenging an item in a taxable year simply by virtue of the fact that it has not challenged it in prior years.

Significantly, the petitioner also claimed that the Service was estopped from disallowing its use of the average-cost method on one sale of stock because it did not challenge the use of that method on eleven other stock sales during the same taxable year. In a footnote, the court responded to petitioner's argument by stating, "Since petitioner admits, however, that its deficiency would be increased were its basis for the remaining eleven sales determined by the FIFO method, we do not think petitioner has reason to complain." Joseph Gann, Inc., at 687.

Similarly, [redacted] has no reason to complain. If the Service increased the service income it received on the [redacted] contract, its deficiency for that year would be increased. In, addition, the mere fact that both the Westreco-foreign parent contract and the [redacted] contract used the same schedule of fees for [redacted]'s services does not establish that such fees were arm's-length. Coors v. Commissioner, 60 T.C. 368, 395 (1973) ("... consistency does not make it right."). See also Madison Gas & Electric Co., at 554-555.

Just recently, the Tax Court reiterated its long-standing position concerning estoppel. Recio v. Commissioner, T.C. Memo 1991-215 (Filed May 16, 1991); Estate of Prince v. Commissioner, T.C. Memo 1991-208 (Filed May 14, 1991). In Estate of Prince, at page 8 of the slip opinion, the court stated:

> Petitioner also suggests that, because respondent was aware of the omission of the project notes from taxable gifts on the 1984 return well before the expiration of the period of limitations for the assessment of a gift tax on April 15, 1988, he should be precluded from collecting that tax indirectly through the determination of a deficiency in estate tax. This position smacks of estoppel against the Government and clearly does not satisfy the standards for such a claim under the decided cases. E.g., United States v. Asmar, 827 F.2d 907 (3d Cir. 1987); Boulez v. Commissioner, 76 T.C. 209 (1981), affd. 810 F.2d 209 (D.C. Cir. 1987).

In Recio, at page 7-8 of the slip opinion, the court stated:

> It is well established that the estoppel doctrine should be applied against the respondent with the utmost caution and restraint. (citations omitted). The essential elements of estoppel are (1) there must be a false representation or wrongful misleading silence; (2) the error must originate in a

> statement of fact and not in an opinion or statement of law; (3) the person claiming the benefits of estoppel must be ignorant of the true facts; and (4) he must be adversely affected by the acts or statements of the person against whom an estoppel is claimed. (citations omitted). ... Petitioners have not satisfied a single element of their claim to equitable estoppel. First, petitioners' statement that respondent's silence was wrongful and misleading is conclusory. While respondent did not question petitioners' claim for two years, his silence was neither wrongful nor misleading. The Court perceives no deceit in respondent's silence. Second, equitable estoppel applies only if one party misrepresents facts to the other party. Whether section 1033 applies to a given set of facts is an issue of law, not an issue of fact. Accordingly, respondent could not have made a factual misrepresentation to petitioners and the second element is not satisfied. ... Fourth, petitioners have not shown that they were adversely affected by respondent's silence. The Court will not speculate as to what petitioners would have done had respondent challenged the claimed deferral earlier. Thus, the fourth element is not satisfied.

The related doctrine of duty of consistency also does not operate to bar the Service from making a section 482 allocation with respect to the [redacted]-foreign parent contract. A duty of consistency applies, for example, where the Service disallows a loss in an earlier year and then is bound to accept the loss as occurring in a later year. Joseph Eichelberger & Co. v. Commissioner, 88 F.2d 874 (5th Cir. 1937); Heath v. Commissioner, 30 T.C. 339 (1958). In Eichelberger, a corporation owned by two individuals sold real property at a loss to another corporation owned by the same two individuals. The revenue agent determined that the sale between these two corporations had no economic substance and, therefore disallowed the loss. The real property was subsequently sold at a loss to an unrelated party, but the Service disallowed the loss on the basis that it was properly deductible in the earlier year. The court held that the Service was bound to accept the deductibility of the loss in the later year because it had accepted the benefit of the disallowance in the prior year.

In Heath, on the other hand, the petitioner claimed that the Service was estopped from taxing $11,000 she received from Newton because the Service also taxed the $11,000 to Newton, the Service refused to refund the tax to Newton and was contesting Newton's refund suit on the issue. The Tax Court stated that, "The taxpayer failed to take a deduction to which he might be entitled or may be precluded by the statute of limitations from the benefit of such deduction. For example, the failure of an employer to claim a salary deduction does not work an estoppel against the collection of income tax on the salary received by the employee." Heath, at 346.

Likewise, the Service is not estopped from including in [redacted]'s income the arm's-length value of the services it performed for its parent corporation, even if [redacted] failed to take a deduction for that higher amount in connection with its contract with [redacted]. As noted in one article, "it is unlikely that such a duty [of consistency] will often be invoked, especially in the absence of irrevocable injury or where different taxpayers are involved." Lynn and Gerson, "Quasi-estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies," 19 Tax Law Review 487, 502 (1964).

Accordingly, we conclude that the Service is not estopped from disputing the arm's-length nature of the fee schedule of the [redacted]-foreign parent contract. [redacted] failed to specially plead estoppel in its Tax Court petition and, therefore may have waived that defense. In addition, the Service made no representation to [redacted] regarding the arm's-length status of the [redacted] contract, [redacted] could not have relied on any Service representation (because there was no representation) and [redacted] arguably knew that the fee schedule in the contracts did not represent arm's-length payment for its services. Moreover, not only did [redacted] not suffer any harm on account of the Service's choosing not to adjust the service income received by it pursuant to the [redacted] contract, it actually benefitted by not having to include the additional in its gross income.

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